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Classified By: Charge d'Affaires a.i. Donald Lu, Reasons 1.4 (b) and (d)

¶1. (C) SUMMARY: In an August 12 farewell meeting with EUR DAS Matthew Bryza, President Aliyev described the latest round of Turkey gas transit talks as going "bad, almost hostile." He instead focused on the prospects of concluding purchase and sales agreements with Greece and its neighbors, and welcomed Bryza's suggestion of the step-by-step realization of the Nabucco vision, if one large pipeline to Austria proved too difficult. SOCAR Vice President Elshad Nasirov stressed Azerbaijan's desire to sell gas to Greece and the Eastern Balkans. He expressed bewilderment at Turkey's demands for transit tariffs far above European norms and at the Turks' seemingly careless preparations for their most recent negotiation in Nakhchivan. Foreign Minister Mammadyarov shared the diplomatic correspondence to date with Turkmenistan over the latter's sudden escalation of the simmering delimitation issue in the Sardar (Kyapaz) field. END SUMMARY.

Turkey Transit Stuck on Price

¶2. (C) President Aliyev characterized Azerbaijan's recent talks in Nakhchivan with Turkey on gas transit as being stuck on the two issues of resolving the price of Shah Deniz Phase 1 gas and establishing a fair and transparent transit tariff. He said the tone was bad, almost hostile, in contrast to the relatively positive tone since Turkish Energy Minister Yildiz came to office. He lamented that Turkey continues to tie together unhelpfully the three issues of Shah Deniz Phase 1 price, Shah Deniz Phase 2 price and gas transit. He did confirm that the price for Shah Deniz Phase 2 gas was almost agreed. Phase 1 gas price remains unresolved, but also is subject to approval by Azerbaijan's corporate partners in this development.

¶3. (C) On gas transit, he said that the Turks had proposed a transit price \$20 above European standard tariffs. He asserted that it is this kind of profiteering that will kill Nabucco. Later, SOCAR Vice President Elshad Nasirov recounted the latest exchange with the Turks. He said he was astonished when Azerbaijan pressed BOTAS chief Sultan Duzyol to explain the rationale for their figure of USD 47 per tcm for the transit of 1 bcm to Greece, and he answered that it had been modeled on Ukrainian proposals to Russia. Nasirov added acidly that "that's why you see Russia putting 25

billion Euro into Southstream to bypass Ukraine." Nasirov laughed as he told Bryza that in response, the Azerbaijani side produced an analysis commissioned by SOCAR of price structures for 7 bcm in nine different scenarios using public BOTAS data to calculate a transit fee comprised of CAPEX, OPEX, and a reasonable profit; SOCAR's analysis suggested a price in the range of USD 27-31 (SOCAR is offering a transit tariff of USD 32, which, Nasirov argued, is one dollar higher than the EU standard of USD 31 per 1000 cubic meters per 100 km). When Yildiz and BOTAS challenged Nasirov on the source of his data, Nasirov said, he was only too happy to tell them that it came from BOTAS' own website. His mirth at that story aside, however, Nasirov was deeply concerned at the lack of a "serious approach" from Turkey to the transit issue.

¶4. (C) Nasirov also explained that while the signing of the Nabucco intergovernmental agreement was a major step forward, Azerbaijan still has a significant issue with the Nabucco consortium on transit, namely that Azerbaijan would prefer to have the right as the potential first supplier to the pipeline notionally to commit its volumes to the first customers in line, e.g. Greece and the Balkan countries, and only pay transit tariffs as far as those destinations, rather than paying "Baku to Baumgarten." Such a formula would maximize the netback to Azerbaijan.

Bilateral Deal With Greece Getting Close

¶5. (C) President Aliyev was happy to report, however, that

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Azerbaijan was in "advanced bilateral discussions" with Greece on a PSA for the sale of gas. Although initial volumes will be small (e.g., 1 bcm), Aliyev believed that this step-by-step approach of beginning with closer consumers and adding pipeline inter-connections incrementally could be a way to achieve a Nabucco-equivalent outcome (Note: That outcome would also sidestep the issue of transit fees on the full length of Nabucco (See para. 4.) End Note.). He believed that next year Azerbaijan would perhaps be able to export 2 bcm of gas to Greece. He noted that the Greeks were worried that the Italians would react negatively since this could be viewed as undermining the Turkey-Greece-Italy pipeline project. Aliyev told the Greeks they should explain that this allows a framework to be built in order to move gas ultimately to Italy. Bryza agreed strongly with the President.

¶6. (C) Nasirov noted Turkey was restricting Azerbaijan's ability to sell gas directly to Greece in a bid to develop into a hub that controlled gas sales into Europe. Turkey had locked itself into a deal according to which it buys gas from Russia and Iran at relatively high prices and sells it to Greece at Turkey's Shah Deniz Phase I price of USD 120 plus a USD 29 transit fee. This results in an effective annual subsidy of Greek consumers by the Turkish Government amounting to USD 224 million. When Nasirov asked BOTAS chief Duzyol why Turkey was charging Greece such a low sales price and a transit fee of only USD 29, while demanding a USD 47 transit fee from Azerbaijan, Duzyol replied that the deal with Greece was the result of a political decision, (thereby admitting BOTAS was not calculating transit fees on the basis of commercial factors). Nasirov countered Duzyol with a proposal to allow Azerbaijan and Greece to reach their own gas sales/purchase agreement, with Turkey charging only a commercially-based transit fee. Under this alternative scenario, the Turkish Government would avoid paying the annual USD 224 million subsidy to Greece and BOTAS could secure attractive revenue from transit fees. BOTAS's refusal to consider this more commercially attractive scenario led Nasirov to believe that BOTAS and the GOT care more about controlling Caspian (and Iraqi) gas exports to Europe than reaching a commercially attractive gas transit arrangement with Azerbaijan.

¶ 7. (C) In response to Nasirov's lamentation on Azerbaijan's difficulty in developing commercial leverage to compel Turkey to settle the two countries' gas transit dispute on commercial grounds, Bryza suggested that Baku open negotiations directly with Athens on a gas sales/purchase agreement. If the two countries reached agreement on a fair price and commercially based transit fee, they could insist that the Turkish Government accept such a deal. The resultant transit fee would provide a benchmark for resolving the Turkey-Azerbaijan gas transit dispute. Ankara would have an incentive to accept this deal out of fear the terms of its existing deal and effective subsidy to Greece would be revealed. Nasirov welcomed this suggestion, and said he would pursue it. FM Mammadyarov also agreed to pursue this option with Greek FM Bakoyannis, but asked Bryza to explain this proposal further at a later date.

Southstream Prospects

¶ 8. (C) Discussing Southstream's prospects following Russian Prime Minister Putin's visit to Ankara, Nasirov and Mammadyarov offered contrasting views. Nasirov said he was certain Russia would build the pipeline because cost is not an object for Moscow if the investment succeeds in isolating Ukraine as a factor in transit to Europe. Russia would recoup the costs anyway through higher prices later. Nasirov speculated that Azerbaijan could seek to ship up to 5 BCM through Southstream, provided Azerbaijan retained title to the gas, as another form of leverage over Turkey. Bryza observed that if Azerbaijan were able to secure third-party access to Southstream in this way, it would be setting a precedent that could have a profound and positive impact for the energy security of European gas consumers and Caspian gas producers. But, Bryza cautioned that such a scheme could only work if Azerbaijan had iron-clad legal guarantees that Gazprom would honor any such agreement; otherwise, (and more

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likely), Gazprom could refuse to allow Azerbaijan to retain title to the gas moving through Southstream once Azerbaijan had committed its gas volumes to this route and foregone the Southern Corridor. Nasirov agreed, and noted this notion of flirting with Southstream was probably too risky, as it could jeopardize the Southern Corridor. Mammadyarov, by contrast, believed that the cost makes Southstream unrealizable in any foreseeable timeframe.

Ashgabat's Challenge to Arbitration

¶ 9. (C) Bryza also discussed with Nasirov and Foreign Minister Elmar Mammadyarov the unusual diplomatic spat with Turkmenistan over the delimitation of the Kyapaz-Sardar field, which Turkmenistan recently demanded be submitted to international adjudication (Reftel). Nasirov told Bryza that Turkmenistan simply "wasn't thinking" when it made its demand, but he saw a silver lining in President Berdimukhamedov's declaration that Ashgabat would abide by an arbitral or judicial ruling. However, he continued, Berdimukhamedov would have done better to have approached Aliyev directly.

¶ 10. (S) The Foreign Minister showed Bryza the diplomatic correspondence to date on the issue, beginning with a July 20 diplomatic note from the GOTX calling for negotiations on the Sardar (Kyapaz) delimitation and admonishing the GOAJ to refrain from negotiating the question in public. There was also a July 28 letter from BP to the GOTX (in response to a GOTX letter) in which the company declined to offer any view on the matter, as it was a dispute between two sovereign states. Finally, there were two diplomatic notes from August 7, the first a GOAJ response to the July 20 note that simply referred the issue back to the Soviet-era basic documents

that provide the fundamental logic for maritime delimitation between the former Soviet states. The same day, the GOTX sent a much longer and tougher note asserting a 100 percent claim to the Sardar (Kyapaz) field and accusing Azerbaijan of using the Azeri and Chirag (Osman and Omar) fields without authority. Azerbaijan's actions were termed "completely unacceptable," and Turkmenistan proposed that the disputes be settled by recourse to "international arbitral and judicial instances."

¶11. (C) Mammadyarov professed no knowledge of which international forum Turkmenistan was referring to, observing that the diplomatic note referred simultaneously to arbitration and to judicial proceedings, which are two different things. He confirmed Bryza's understanding that both countries would need to formally submit to ICJ jurisdiction to pursue that route, hardly an immediate possibility. Bryza suggested to the Minister that perhaps Berdymukhamedov's threat of arbitration actually suggested a willingness to resolve the dispute and thereby clear the way for westward gas exports, but in a way that affords him cover with Russia. The Minister replied this might be the case, but preferred for Turkmenistan to create negotiating leverage on Russia by increasing its westward outreach, citing Baku's diplomatic success in bringing Turkey back to the table by making a limited deal with Russia to supply gas to Dagestan in late June 2009.

¶12. (C) Comment: The President and his officials present a confident face on energy issues, but are clearly frustrated by Turkish gamesmanship on the transit issue. It also appears as though the honeymoon with Ankara's new energy minister is over (while Baku certainly would not ask for Guler bac, the expectations for a changed relationship with Yildiz in the minister's office seem to have moderated. President Aliyev commented, "All the latest actions by the Turks, whether deliberate or not, are against Azerbaijan and Western interests. We need to know what to do."

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